BRIEFING: MARCH 2010 EXECUTIVE/ADMINISTRATIVE COMMITTEE MEETING AGENDA ITEM #5

TO: **Chairman Pringle and Authority Board Members**

FROM: **Jeffrey M. Barker, Deputy Director**

DATE: **2/22/10**

RE: **Business Plan Addendum**

Introduction

Authority staff submitted to the Legislature an updated business plan document on Dec. 14, 2009. Since that time, the plan has undergone much scrutiny, including three Legislative committee hearings, and has brought about a number of questions from the public. Additionally, several events have occurred over the two months since its submission that warrant updating.
Authority staff proposes to produce an addendum to the business plan and to bring the plan before the Authority Board for approval for submission to the Legislature.

Business Plan in Need of an Addendum

A number of questions, criticisms and events that have occurred since the submission of the 2009 business plan document warrant an addendum to the document:

- Questions. A number of issues discussed within the business plan have been misunderstood and therefore merit further discussion. Among these are the scenarios outlined for ticket costs and annual ridership amounts. The Legislative Analyst's Office (LAO) raised a number of questions, including about the project's timeline of milestones.

- Criticisms. The LAO said the business plan, upon further development, would need to discuss in much greater detail the risks associated with the project. The Authority's ridership forecasts, while not directly related to information contained within the revised business plan, have in recent months received criticism.
- Events. Since the submission of the plan, California won $2.25 billion in American Recovery and Reinvestment Act funding for the project. Additionally, since public outreach is a central part of the business plan, it is worth noting and discussing that the Authority recently brought on a new statewide communications and outreach consultant.

Legislators' Requests for Further Information

Several legislators have taken an active interest in the development of the high-speed train project and its business plan. Chief among them are Senator Alan Lowenthal and Senator Joe Simitian, chairs of the Senate Transportation and Housing Committee and Senate Budget Subcommittee #2, respectively.

The senators have requested answers to questions raised on the project's ridership numbers and on risk assessment. They have requested these answers prior to state budget discussions.

Staff Recommendation

Direct staff to complete the above-described addendum to the 2009 Business Plan and bring the result to the April 2010 Board Executive/Administrative Committee for approval.

Attachments:

- ✓ "The 2009 High-Speed Rail Business Plan" review by the Legislative Analyst's Office, 1/11/2010
- ✓ Infrastructure Management Group Memo re: "Minimum Revenue Guarantee," 2/21/2010

January 11, 2010

The 2009 High-Speed Rail Business Plan

LEGISLATIVE ANALYST'S OFFICE

Presented to:

Assembly Transportation Committee

Hon. Mike Eng, Chair

LAO 65 YEARS OF SERVICE

2008 High-Speed Rail Business Plan

☑ ***Requirement.*** Chapter 267, Statutes of 2008 (AB 3034, Galgiani), required the High-Speed Rail Authority to submit a business plan for the high-speed train system to the Legislature by September 1, 2008. The plan was released on November 7, 2008.

☑ ***Plan Lacked Specifics.*** Information provided in the plan was very general and did not provide specifics that are included in typical business plans. The figure below summarizes our review of the 2008 plan. (See *2009-10 Budget Analysis Series: Transportation*, page TR-47.)

2008 Business Plan Fails to Provide Many Details

Statutory Requirements	Sample of Missing Details
Description of the anticipated system	• What are the expected service levels, by segment? • What is the assumed train capacity?
Forecast of patronage, operating, and capital costs	• How are the ridership estimates projected? • What is the operating break-even point? • How will costs be distributed by route segment?
Estimate of necessary federal, state, and local funds	• How would funds be secured? • What level of confidence is there for receiving each type of funding?
Proposed construction timeline for each segment	• What is the proposed schedule, by segment, for completing design/ environmental clearance? • For beginning/completing construction?
Discussion of risks and mitigation strategies	• How would each type of risk impact the project? • What specific mitigation strategies are planned to be deployed?

LAO
65 YEARS OF SERVICE

2009-10 Budget Requires Business Plan Revision

☑ ***2009-10 Budget Requirement.*** The current year budget directed the authority to submit a revised business plan to the Joint Legislative Budget Committee by December 15, 2009.

☑ ***Required Elements.*** The revised plan must include, at a minimum:

- A plan for a community outreach component to cities, towns, and neighborhoods affected by the project.
- Further system details, such as route selection and alternative alignment considerations.
- A thorough discussion describing the steps being pursued to secure financing.
- A working timeline with specific, achievable project milestones.
- The strategies the authority would pursue to mitigate different risks and threats.
- Additional information related to funding, project development schedule, proposed levels of service, ridership, capacity, operational plans, cost, private investment strategies, staffing, and a history of expenditures and accomplishments to date.

LAO
65 YEARS OF SERVICE

Revised Business Plan Improved

☑ ***Revised Plan More Informative in Some Areas.*** The revised plan includes at least some description of all the elements required by the 2009-10 budget. The plan also provides more information than the previous version in certain areas.

- ***Community Outreach.*** Though the authority only recently obtained their public relations consultant, the plan contains a summary description of a community outreach plan.
- ***System Details.*** The plan includes:
  - General route selection and various alternative alignments.
  - Updated cost estimates using year-of-expenditure dollars.
  - Forecasted ridership, revenues, and proposed levels of service.
  - Projected operating and equipment replacement costs.
- ***Funding.*** Descriptions of various types of financing available and possible funding sources for the project are included.
- ***Authority Operations.*** The plan provides a short discussion of necessary future staffing for the authority as well as historic levels of funding.

LAO
65 YEARS OF SERVICE

Some Significant Details Still Missing

- ☑ ***Inadequate and Incomplete Discussion of Risk.*** The plan's discussion of risk management is significantly inadequate, lacking any description of mitigation processes or detailed consideration of many key types of risk.

- ☑ ***Uninformative Timeline.*** Few deliverables or milestones are identified in the plan against which progress can be measured. Also, inconsistencies in the proposed order of events create some uncertainty.

Risk Discussion Incomplete and Inadequate

- ***No Risk Management Strategy.*** The plan contains no discussion of the authority's plans or processes to (1) identify potential threats or (2) manage, respond, and mitigate those threats. The plan only states that the authority "believes it is aware of all existing threats and is taking the appropriate steps to prevent or mitigate those threats."

- ***Unknown Confidence in Projections.*** The plan does not provide any numerical ranges nor confidence intervals for projections contained in the plan (such as cost, revenues, or ridership). Without this information, the risk of not realizing the forecasted ridership, revenues, or costs is unknown.

- ***Inadequate Discussion of Key Types of Risks.*** The plan contains no detailed discussions or consideration of even the most significant risks to the project, such as ridership and funding.

LAO
65 YEARS OF SERVICE

Discussion of Risk–Two Examples

- ☑ ***Ridership Risk.*** The plan addresses the risk of incorrectly forecasted ridership with one sentence, stating the risk "would be mitigated by policies that continue to draw people to reside in California and encourage high-speed rail as an alternative mode of transportation."

- ☑ ***Funding Risks.*** The plan identifies the following types of financial risks, and how these risks would be addressed:

  - ***Credit Approval Risk.*** To avoid the risk of failing to win credit approval from investors, the authority's strategy is "to clearly communicate the project and obtain up-to-date feedback."

  - ***Overall Market Risk.*** To mitigate the risk that financial markets shut down and stop lending, the authority "has to continually monitor the market and develop strong back-up strategies such as project segmentation."

  - ***Government Funding Risk.*** The authority plans to avoid the risk that governments are not able to follow through on their commitments "by carefully assessing how each government funding source affects the build-out of each segment."

LAO
65 YEARS OF SERVICE

Timelines Very General and Potentially Inconsistent

- ☑ ***Uninformative Timeline.*** The program management and project delivery timelines contained in the plan are very general and provide little opportunity for increased accountability. There are few deliverables or milestones included against which progress can be measured.

- ☑ ***Inconsistent Order of Events.*** Because the timelines in the plan are so general, it is unclear in what order various events will occur. For example, regulatory approvals are expected by 2018 but procurement is scheduled to be complete by 2014. This could mean the train technology and rolling stock will be procured before regulatory agencies approve their use.

LAO
65 YEARS OF SERVICE

Funding Plan Uncertain; Appears to Violate Law

☑ ***Operating Subsidy Necessary for Private Funding.*** The Proposition 1A bond measure explicitly prohibits any public operating subsidy. However, the plan expects the following items to be funded by the private sector.

- ***Revenue Guarantee.*** The plan assumes some form of revenue guarantee from the public sector to attract private investment. This generally means some public entity promises to pay the contractor the difference between projected and realized revenues if necessary. The plan does not explain how the guarantee could be structured so as not to violate the law.

- ***Operations Insurance.*** The plan anticipates the cost of insurance for operating the system would not be borne by the private operator. If the public sector pays for insurance, that would constitute an operating subsidy in violation of Proposition 1A.

☑ ***Federal Funding Expectations Highly Uncertain.*** The plan assumes between $17 billion and $19 billion from federal funds by 2016, or nearly $3 billion per year for the next six years. In comparison, over the past five years California has received roughly $3 billion per year of formula funding for the state's entire highway system, which is primarily funded through federal gas tax collected in the state

TO: Curt Pringle, Mehdi Morshed, Jeff Barker, CA High-Speed Rail Authority

FROM: Sasha Page, Alene Tchourumoff, Infrastructure Management Group

DATE: February 21, 2010

RE: Minimum Revenue Guarantee

You have asked us to provide clarification on the recommendation in the Authority's 2009 Business Plan (the Business Plan) for a minimum revenue guarantee to secure some of the financing for the Phase I project. Please find below such a clarification that we believe will be accepted in the financial marketplace and conform with the Proposition 1A Bond Measure (the Bond Measure) requirements.

The revenue guarantee is discussed on pages 101-106 in the Business Plan. From page 103 of the Business Plan it is described as follows:

> *Implicit in these assumptions is some form of a revenue guarantee that would guarantee to private sector participants that a minimum level of revenues would be received in the event that system revenues are significantly lower than forecast.*

We believe that this revenue guarantee should be further defined as follows:

- The revenue guarantee would **not** be used as an operating subsidy in the Authority's funding plan, which is prohibited in the Bond Measure. Such an operating subsidy implies that the system is not projected to generate sufficient revenues to cover operating costs. Unlike transit systems that often require long-term operating subsidies, the Authority's current ridership and revenue projects show that the project will in fact **generate operating surpluses.**

- Rather, the minimum revenue guarantee would be modeled in the funding plan as **a limited term contingent liability** to support up-front capital investments. This proposed structure would make it distinct from an operating subsidy in the following ways:

    - As a contingent liability, it would only be made available to fund a **portion of previously identified financing and capital costs** when certain benchmarks are not met. For instance, this could be calculated as a percentage of projected net revenues, e.g., 80 percent, that would balance the goal of incentivizing efficient high quality service by the operator with the risk profile of the lenders given market conditions at the time of receipt of bids**.**

- The Authority could structure the revenue guarantee mechanism in its agreement with the operator such that the operator would still be required to cover project operating expenses from project revenues or reserves, but could be eligible to have part of its capital related costs defrayed. **This type of capital cost-only limitation has been employed both in federal and state highway and transit projects and cannot in any sense be considered an "operating subsidy."**

- Enforcement of this requirement could involve a number of measures, including 1) the requirement that the recipient of the revenue guarantee **certify** that the funds have only been used for capital costs and/or 2) that the recipient's financial accounts could be **audited** by an a third-party appointed by the Authority, and/or 3) that the parties refer to a **financial model** that would be produced either by the Authority or the selected operator (yet audited by a third-party) that would determine the guarantee amount based calculations established at signing of the concession.

- Unlike transit that often requires long-term guarantees, the revenue guarantee would be designed to be **limited in duration (5-10 years)** to demonstrate demand forecasts during ramp up period for new high-speed mode.

We hope that this clarification is helpful.